

## Ask the experts:

# Unwelcome but practical answer

Why should corporates check that their debt/equity level and debt composition are optimal?



**Andrew Moorfield, MD,  
Lloyds TSB Corporate Markets**

An optimal debt/equity (D/E) ratio will maximise investment opportunities. By managing debt composition, some of the risk associated with increased levels of debt can also be hedged.

Indeed, compared with the cost of debt, the cost of equity is more expensive as it is not tax-deductible and it requires a premium to reward equity holders for being subordinate to debt holders.

The lower the combined cost of debt and equity – the weighted average cost of capital (WACC) – the greater the number of investment opportunities available. This is because value is, theoretically, created when new investments exceed a company's WACC. The lower the WACC, the greater the range of positive investments. A company is therefore at a strategic advantage, relative to its competitors, if it increases its scope of investment opportunities.

But as debt levels increase – and WACC falls – the risk of financial distress increases. Unlike equity holders, debt holders require both an interest and an eventual principal payment. And as cashflows increasingly service debt, so companies with higher levels of debt raise the likelihood of financial distress.

The presence of financial covenants offers another variable. As headroom narrows between actuals and covenants, so a company's financial flexibility narrows. A similar role can be performed by the rating agencies – a company will require certain leverage ratios to maintain a credit rating.

This is the gap that optimal debt composition can fill. Given its ability to stretch debt across numerous instruments and institutions, the corporate can at least partially insulate its financing structure from refinancing risks by staggering the timing of each refinancing.

Diversity of fund sourcing will also offer access to competitive pricing, and, more importantly, a variety of debt sourcing can reduce the corporate's reliance on a small number of bank lending relationships.



**Ian Byrne, Director of Ratings  
Services, Standard & Poor's**

Debt/equity optimisation and debt composition management have traditionally been about a company's cost of capital. And one of the key elements in determining the cost of capital is the market appetite for a company's paper.

In this respect, a company's credit rating (and the ratings carried by the debt it issues), assessed on the basis of the information the company provides to the market, can have a significant effect on the company's cost of capital. And that makes credit ratings a key element of debt/equity optimisation.

Certainly, any analysis of optimisation needs to look deeper than credit ratios and incorporate both quantitative and qualitative aspects. It needs to understand the business risk impact on ratings, the financial risks of any capital raising, and the probable impact of any financial strategy on the rating.

A company may wish to gear up – to fund an acquisition, to increase its capital expenditure or simply because it believes that a higher debt/equity ratio is in the best interests of its shareholders. But it needs to do so with an awareness that such activities may also affect its credit rating.

But corporates and their advisers do not need to work in the dark. Scenarios can be presented to Standard & Poor's for evaluation and testing of their credit rating impact. Indeed, the agency has a formal rating evaluation service aimed at both rated and unrated companies wishing to gauge the impact of balance sheet engineering.

In the scenarios presented to the agency, different levels of debt can be presented, as well as mixes of different types of debt including senior secured, senior unsecured, subordinated, mezzanine or hybrid.

The potential ratings-level effects of notching the different types can also be ascertained. In this way the company can continually optimise its capital structure in a constantly changing world, and do so with an understanding of the ratings impact of any changes it is considering.



**John Hawkins, former Head of  
Finance and Risk, Invensys**

The corporate finance principle of seeking to optimise debt levels by reaching the point at which the incremental tax benefits gained equal the incremental insolvency costs incurred is now well understood, but there are at least two problems. First, it is by no means so well understood how firms can judge in practice whether they have reached this point. Second, not all stakeholders in publicly quoted companies have necessarily signed up to the theory.

Management styles can vary considerably, but many will adopt a more cautious approach than the textbooks suggest. This is usually because they feel that spare debt capacity has some value – for example, in connection with unexpected investment or acquisition opportunities. Certainly, raising additional debt finance is usually easier than raising additional equity finance, even when the underlying story is good.

Banks (as lenders), bondholders and credit rating agencies may also take a more conservative view, not least because they are looking at the value of debt, rather than the value of the firm as a whole. This is not to say that the increased cost of more risky debt does not fairly reflect the increased risk, but in many corporate situations debt tends to become high risk, rather than be issued at that risk level.

Given this backdrop, it is not surprising that some traditional equity investors also seem to prefer modestly underleveraged companies.

The consequence? Investors who are prepared to accept higher debt levels and to package risk more innovatively through more sophisticated capital structures can move towards the optimum and, therefore, extract value. It is no coincidence that both of these are often easier in an unquoted (that is, a private) environment.

The result? Massive recent growth in leveraged deals, and probably more to come. Ironically, unwelcome bids from private buyers may provide the practical answer to the first problem, by indicating when you are well below the optimal leverage point.